IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX REFERENCE NO.110 OF 1990

Shri P.H. Hamid,
C/o.Publicity Printers,
28-D, Police Court Lane,
Bombay. ...Applicant

V/s.

Commissioner of Income-tax,
Bombay City-IV, Bombay. ...Respondent

Mr.B.V. Jhaveri i/b. J.I. Patel for Applicant.
Mr.A.N. Kotangle, Sr.Counsel with Mr.D.A. Dubey i/b. K.C. Sidhwa for Respondent.

CORAM : V.C. DAGA AND
A.S. AGUIAR, JJ.

DATED : JULY 21, 2005.

ORAL JUDGMENT (PER V.C. DAGA, J.) :-

. By this reference under Section 256 (1) of Income-Tax Act, 1961 (the I.T.Act), the Income Tax Appellate Tribunal (the Tribunal for short), Mumbai, has referred the following questions for the opinion of this Court. The Assessment year involved is 1980-81.

1) Whether on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the assessee had

claimed depreciation on the machinery and, therefore, the assessee is liable to tax on profits of Rs.2,13,705/- u/s. 41(2) of the I.T. Act, 1961?

2) Whether on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the assessee is liable to tax on profits u/s.41(2) of the I.T. Act, 1961, even though depreciation was claimed by the partnership firm which was dissolved and the machinery were allotted to the assessee who sold the same after dissolution of the firm?"

The Facts :

2. In this case, the assessee was a partner of the firm, known and styled as M/s. Publicity Printers, with his wife. The said firm was dissolved by a dissolution deed dated 26.12.78 with effect from 15.12.78. On the dissolution of the firm, certain assets of the erstwhile firm were allotted to the assessee on which depreciation was claimed by the said firm of M/s.Publicity Printers prior to its dissolution. Out of certain assets

allotted to the assessee, three machines were sold by him immediately after dissolution of the firm to three different parties for a total consideration of Rs.7,03,107/-. The cost of the said machines in the hands of the firm was Rs.3,23,937/- and the written down value of these machines, as on the date of dissolution, was Rs.1,10,232/-. The assessee invested the sale proceeds in specified/assets u/s 54E of the I.T. Act, 1961, and claimed exemption from payment of tax on long-term capital gains amounting to Rs.3,79,170/- (sale price Rs.7,03,107/- less cost Rs.3,23,937/-). while completing the assessment, the Income-tax Officer (ITO) taxed the assessee on a sum of Rs.2,13,705/- (cost Rs.3,23,937/- less written down value Rs.1,10,232/-) treating it as profits earned by the assessee u/s. 41(2) of the I.T.Act, 1961.

3. In appeal, the Commissioner of Income-tax (Appeals), CIT (A), did not accept the contention of the assessee and confirmed the order of the ITO. The Tribunal, in the appeal preferred by the assessee, upheld order of the CIT (A), relying on the analogy and the principles laid down by the Hon’ble Supreme Court in the case of **M/s.Malabar Fisheries Co. vs. CIT (120 ITR**

49).

Statutory Provisions :

4. With the aforesaid facts, it is necessary to look into the relevant statutory provisions to answer the question referred to this Court for opinion under Section 41(1) and (2) :-

> 41(1) Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee, and subsequently during any previous year the assessee has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by him or the value of benefit accruing to him, shall be deemed to be profits and gains of business or profession and accordingly chargeable to income-tax as the income of that previous year, whether the business or profession in respect of

which the allowance or deduction has been made is in existence in that year or not.

(2) Where any building, machinery, plant or furniture which is owned by the assessee and which was or has been used for the purposes of business or profession is sold, discarded, demolished or destroyed and the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceed the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business or profession of the previous year in which the moneys payable for the building, machinery, plant or furniture became due :

Provided that xxx

Provided further that xxx

Explanation : Where the moneys payable in

respect of the building, machinery, plant or furniture referred to in this sub-section become due in a previous year in which the business or profession for the purpose of which the building, machinery, plant or furniture was being used is no longer in existence, the provisions of this sub-section shall apply as if the business or profession is in existence in that previous year.

(2A) xxx

(3) xxx

(4) Where a deduction has been allowed in respect of a bad debt or part of debt under the provisions of clause (vii) of sub-section (1) of section 36, then, if the amount subsequently recovered on any such debt or part is greater than the difference between the debt or part of debt and the amount so allowed, the excess shall be deemed to be profits and gains of business or profession, and accordingly chargeable to income-tax as the income of the previous year in which it is recovered, whether the business or

profession in respect of which the deduction has been allowed is in existence in that year or not."

(5) xxx

5. With a view to ensure that there is no loss of revenue and undue enrichment to the assessee, sub-section (1) of section 41 has been substituted by the Finance Act, 1992, so as to bring to tax the amount or benefit, as the case may be. In cases where the recipient is a successor in business and is other than the person who was allowed the deduction earlier has also been brought to the tax. This provision was absent prior to 1st April, 1993. The amended provision has taken place on 1st April, 1993, so as to make it applicable to the assessment year 1993-94 and subsequent assessment years. We are dealing with the reference arising out of an order meant for Assessment Year 1980-81.

6. The scope and effect of above amended provision has been elaborated in the department circular no.762, dated 18th February, 1998, as follows :-

> "Modification of provisions relating to profits chargeable to tax, - **28.1** Sub-section (1) of section 41 deals with profits chargeable to tax. Clause (a) of this sub-section provides that where an allowance or a deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee, and subsequently during any previous year, the assessee has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained or the value of benefit accruing to him shall be deemed to be the profits, and accordingly chargeable to income-tax as income of that previous year, whether the business or profession in respect of which the allowance or deduction has been made

is in existence in that year or not. Clause (b) of this sub-section makes similar provision in the case of successor in business in regard to any amount in respect of which loss or expenditure, etc., was incurred by the predecessor."

28.2 It was found that a number of assessees were escaping tax liability under this sub-section in regard to the credit of trading liabilities to profit and loss account, even when the recovery of the debt had become barred by limitation or when there was no likelihood of the liability being enforced against them. This was on account of the fact that some courts held that the liability can remit or cease only by a bilateral or a multilateral act between the creditor(s) on the one side and the debtor on the other and not by a unilateral act. By an amendment the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof", occurring in this sub-section, has been defined to include the remission or cession

of any liability by a unilateral act by the first mentioned person under clause (a) or the successor in business under clause (b) of this sub-section by way of writing off such liability in his accounts."

Consideration :

7. Section 41 (unamended) enacts adjustment provisions whereby the Revenue takes back what it has already allowed if certain conditions come to pass and the assessee recoups something for which an allowance had already been made and deducted from his business income. Each of the six sub-sections of section 41 enumerate a particular circumstance and provide that if such circumstance comes to pass, certain income would be made taxable as deemed income. The section further fixes the year in which the recoupment, etc., is to be taxed. The year, generally, is that in which the recoupment amount becomes payable or the alternative benefit, etc., comes to be obtained.

. Section 41(2) stipulates that - Where any building, machinery, plant or furniture which is owned

by the assessee and which was or has been used for the purposes of business or profession is sold, discarded, demolished or destroyed and the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceed the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business or profession of the previous year in which the moneys payable for the building, machinery, plant or furniture became due. The above provisions, therefore, contemplate sale of the fixed assets by the assessee itself who has claimed depreciation in the previous year.

8. The facts in the case on hand, undisputedly, make it clear that the assessee was a partner of the firm known as M/s.Publicity Printers. The said firm was dissolved by dissolution deed dated 26th December, 1978 with effect from 15th December, 1978. On the dissolution of the firm, certain assets of the erstwhile firm were allotted to the assessee. The assessee sold these assets. On these depreciation was claimed not by

the assessee but by the firm M/s.Publicity Printers. It is, thus, clear that sale has not been effected by the person or assessee by whom the benefit of depreciation on the property in question was taken. Therefore, the question is can the amount of depreciation availed by the partnership firm is liable to be brought to tax and be taxed in the hands of the assessee i.e. successor to the property.

9. Learned Counsel appearing for the applicant placed reliance on the Judgment of the Apex Court in the case of **BIST and Sons V/s. Commissioner of Income-Tax, New Delhi, (1979) 116 ITR 131**, wherein the Hindu undivided family consisting of a father and his son carried on the business of forest contractors. Three trucks were used in the course of business and the family availed of all the depreciation allowance thereon and their written down value had become 'nil'. On total disruption in the family, the father and son formed a partnership firm and took over the business as a running concern. The firm, thereafter, sold the three trucks for an aggregate sum of Rs.24,252/-. The question was whether the sum could be brought to tax in the hands of the firm as deemed profit under the second proviso to

Section 10(2)(vii) of the I.T. Act, 1922. These facts had given rise to question as to whether sum of Rs.24,252/- was an item taxable in the previous year under the provisions of Section 10(2)(vii)?

10. While dealing with the above question, the Apex Court held that "the Hindu undivided family "and "the firm" were distinct entities, the depreciation allowed to the family could not be regarded as depreciation allowed to the firm. The second proviso to section 10(2)(vii) was not attracted as such sum of Rs.24,252/- was not taxable in the hands of the firm as deemed profit under the second proviso to Section 10(2)(vii)." It was further observed that "it was immaterial that the business was taken over as a running concern by the firm." The Apex Court while laying down this law ruled that under the Income Tax Act, the firm is a distinct assessable entity. Section 3 of the Indian I.T. Act, 1922, was relied upon to show that income tax legislation treats it an such, and the entire process of computation of the income of a firm proceeds on the basis of its distinct assessable entity. The Apex Court also relied upon the Judgment of **CIT V/s. A.W. Figgies and Company (1953) 24 ITR 405 (SC)**. The Apex Court

further held that when the depreciation was allowed to the HUF in assessment proceedings, it was a step taken in determining the taxable income of the family. It ruled that the depreciation allowed to the family cannot be regarded as depreciation allowed to the HUF and it was completely ignored. It was, thus, held that the proviso to Section 10(2)(vii) was not attracted and that an amount of Rs.24,252/- was not taxable in the hands of assessee for the assessment year 1957-58.

11. Learned Counsel for the applicant-assessee also relied upon the Judgment of the **Delhi High Court** in the case of **Commissioner of Income-Tax V/s.B.R. Chawla, (2001) 248 ITR 205** wherein the assessee was an individual, who was carrying on business as a successor to a firm. The firm was required to pay certain additional licence fee imposed by the Excise Department during the assessment year 1968-69. Subsequently a part of the duty was refunded by the Excise Department; out of which Rs.18,255/- were received by the assessee being the successor of the partnership. The Income-tax Officer held that the amount was taxable under Section 41(1) but the Appellate Assistant Commissioner directed exclusion of the amount from the assessment. The order

of the Appellate Assistant Commissioner was upheld by the Tribunal. On a reference, the High Court held that "the deduction was allowed in the hands of a partnership firm whereas the assessee concern was an "individual". Merely, because he was carrying on business in succession to the earlier partnership firm's business, that would not per se make him the "assessee" covered under section 41(1). High Court relied upon Section 2(31) of the Act, which defines "person" to include an "individual" and a "firm" separately. Section 2(7) of the Act defines an "assessee". High Court ruled that by no stretch of imagination could the firm in respect of whom the expenditure was allowed be treated to be the assessee; who was an individual. The amount of Rs.18,255/- representing refund of additional licence fee received from the Excise Department was held not taxable under section 41(1) in the hands of the assessee."

12. Learned Counsel for the applicant also relied upon one more Judgment from **Punjab and Haryana** High Court in the case of **Commissioner of Income-Tax V/s. Shri Sat Parkash, (1989) 178 ITR 393**, wherein the assessee-firm was originally constituted in 1958 with

three partners. There were changes in the constitution of the firm in the years 1960 and 1962. During the assessment years 1961-62 and 1962-63, the firm discharged its sales tax liability amounting to Rs.8,261/-. In the year 1967, a sum of Rs.4,500/- was received by the firm as refund of sales tax which was credited to the account of the then existing two partners in equal shares. This amount was, however, not shown in the return of the firm or of the partners of the firm for the assessment year 1968-69. The Income-tax Officer treated the refund of Rs.4,500, as deemed income of the firm under Section 41(1) of the Income-tax Act, 1961, as also Rs.2,250/- each, in the hands of the two partners and assessment was finalised accordingly. Penalty proceedings were then initiated against the firm and the two partners. The penalty was however deleted by the Tribunal against both the firm and the two partners holding that penalty provisions were not applicable to ’deemed income’. The High Court upheld the order of the Tribunal deleting the penalty against the firm. The High Court held that keeping in view the definition of "person" given in Section 2(31) of the Act, a person includes a firm which means that the firm will succeed a firm while its partners in their

individual capacity are separate and distinct assessees. By virtue of Section 41(1) of the Act, it was held to be the deemed income in the hands of the assessee That being so, it was held not permissible under Section 41(1) of the Act to add the amount in question, that is, the amount received by way of refund by the erstwhile partners of the firm in their individual capacity.

13. Learned Counsel submitted that in order to attract the provisions of Section 41(1) of the Income-tax Act, 1961, the identity of the assessee for the previous year and the subsequent year must be the same. If there is any change in the identity of the assessee, there would be no tax liability under Section 41(1). He relied upon the Judgement of the Madras High Court in the case of **Commissioner of Income-Tax, Tamil Nadu-I V/s. P.K. Kaimal, (1980) 123 ITR 755** and that of the Apex Court in **Saraswati Industrial Syndicate Ltd. V/s. Commissioner of Income-Tax, Haryana, ITR (1990) 186 ITR 270** in support of his submission.

14. Relying upon the aforesaid Judgments, learned Counsel for the applicant submits that the principle laid down by Apex Court as well as other High Courts

while interpreting Section 41(1), would hold good even for interpretation of the provision of Section 41(2) of the Act. He, thus, submits that in view of change of identity of the assessee, the said provisions would not be applicable.

15. Per contra, learned Counsel Mr.Kotangle, appearing for the Revenue tried to support the view taken by the Tribunal relying upon the Judgment of the Apex Court in the case of **M/s.Malabar Fisheries Co. vs. CIT (1979) 120 ITR 49).** Mr.Kotangle submits that the partnership firm under the Indian Partnership Act, 1932 is not a distinct legal entity apart from the partners constituting it and equally in law the firm as such has no separate rights of its own in the partnership assets. According to him, when one talks' of the firm's property or the firm's assets all that is meant is property or assets in which all partners have a joint and common interest. In his submission, it cannot, therefore, be said that upon dissolution the firm's right in the partnership assets are extinguished. It is the partners who own jointly or in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the

partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between the partners and there is no questions of any extinguishment of the firm's rights in the partnership asset amounting to a transfer of asset within the meaning of section 2(47) of the Income Tax Act, 1961. In his submission even after dissolution of the partnership, if the assets are allotted to the partners and those assets are sold, in that event whatever benefits are taken by the partnership firm are liable to be restored by the partners of the firm.

Consideration :

16. Having heard rival contentions, the proposition of law canvassed by both of them relying upon the two different Judgments delivered by the same three Judges Bench of the Supreme Court, are well established. So far as the case of **Malabar Fisheries Co.** (Supra) is concerned, in that case, following the Judgment of the Privy Counsel in **Bhagwanji Morarji Goculdas v. Alembic Chemical Works Co.Ltd., AIR 1948 PC 100** Supreme Court observed thus :-

"Before the Board it was argued that under the Indian Partnership Act, 1932, a firm is recognised as an entity apart from the persons constituting it, and that the entity continues so long as the firm exists and continues to carry on its business. It is true that the Indian Partnership Act goes further than the English Partnership Act, 1890, in recognising that a firm may possess a personality distinct from the persons constituting it, the law in India in that respect being more in accordance with the law of Scotland, than with that of England. But the fact that a firm possesses a distinct personality does not involve that the personality continues unchanged so long as the business of the firm continues. The Indian Act, like the English Act, avoids making a firm a corporate body enjoying the rights of perpetual succession." (Emphasis supplied).

. It is true that under the Civil Procedure Code, O.XXX, as under the English Rules of Court, actions may be brought by or against partners in the name of the firm and

> even between firms and their members but that is only a matter of procedure. It is also true that the firm's property is recognised in more than one way (ss. 14 and 15 of the Partnership Act) but only as that which is "joint estate" of all the partners as distinguished from the "separate estate" of any of them, and not as belonging to a body distinct in law from its members."

17. In another judgment in the case of **Addanki Narayanappa v. Bhaskara Krishnappa (1966) 3 SCR 400; AIR 1966 SC 1300** Apex Court after quoting with approval the aforesaid passage made the following observation in the context of the partner's right during the subsistence as well as upon dissolution of a firm.

> "No doubt since a firm has no legal existence, the partnership property will vest in all the partners and in that sense every partner has an interest in the property of the partnership. During the subsistence of the partnership, however, no partner can deal with any portion of the property as his own. Nor can he assign his

> interest in a specific item of the partnership property to any one. His right is to obtain such profits, if any, as fall to his share from time to time and upon the dissolution of the firm to a share in the assets of the firm which remain after satisfying the liabilities set out in cl.(a) and sub-cls. (i), (ii) and (iii) of cl.(b) of s.48."

18. Having regard to the above, it is clear that so long as the partnership continues, the firm possesses the distinct status of partnership and continues to be so so long as business of the firm continues. In the case of **Malabar Fisheries Co. V/s. CIT** (Supra), the Apex Court was dealing with the question of transfer of properties of the dissolved firm; whereas in the case of **BIST and Sons** (Supra), the Apex Court was considering the case of running partnership firm; which was a partnership firm distinct from its partners. In that contest, the Apex Court ruled that for the purposes of the Income Tax Act, the partnership firm is a distinct and separate assessable entity. It is, thus, well established that recognised by law that so long partnership business continues, it has its own

independent existence distinct from its partners and its partners have a distinct status independent of the partnership firm.

19. Having noticed the difference between the status of the partners of a living partnership firm and that of dissolved firm, the assessee/applicant cannot be said to be a person who had reaped the fruits of the depreciation enjoyed by the firm when it was a living partnership firm. The sale of properties of the dissolved partnership will not attract tax on the amount of the depreciation enjoyed by the partnership firm. That amount cannot be brought to tax.

20. Having recorded this finding, the question referred for our opinion will have to be answered in negative i.e. against the Revenue and in favour of the Assessee.

. Reference, accordingly, stands disposed of with no order as to costs.

(A.S. AGUIAR, J.) **(V.C. DAGA, J.)**